



CONTEMPORARY  
FINANCIAL MANAGEMENT

UPRAVLJANJE FINANSIJAMA U  
SAVREMENIM USLOVIMA  
POSLOVANJA

DOI: 10.15308/finiz-2015-73-77

# THE CHALLENGES OF INTERNAL AUDIT IN CONTEMPORARY FINANCIAL MANAGEMENT

Ema Marinković\*, Marina M. Šestović

Singidunum University, Faculty of Economics, Finance and Administration - FEFA, 44 Zoran Djindjic Blvd., Belgrade, Serbia

## Abstract:

The global and financial crises have created the need for changes in the legal and regulatory requirements with the aim to promote and establish better corporate governance. Internal audit is an integral part of good corporate governance and its task is to ensure credibility of the financial reporting process. Internal audit should be seen as a management tool that will enable managers to provide a realistic picture of organizations and their operations, performances, potential hazards, as well as the opportunities for improvement. Internal audit development has undergone significant challenges in numerous countries due to different strengths of accounting standards being used, the availability of institutional capacities and the existence of social consensus to carry out audit in the public sector. There is a need in contemporary financial management to strengthen the overall audit function. This particularly applies to developing countries, including Serbia.

In this paper, the authors examine the challenges of internal audit in both private and public sector and reach the conclusion that the modern business principles require that the internal audit function is based on the estimation of future trends and risk predictions.

## Key words:

internal audit,  
public sector,  
good corporate governance,  
financial management and control,  
public internal financial control.

## Acknowledgment:

This research paper is the part of the project "Advancing Serbia's Competitiveness in the Process of EU Accession", No. 47028, for the period 2011-2015, financed by the Ministry of Education, Science and Technological Development.

## 1. INTRODUCTION

At the beginning of this century financial markets and the global economy were shaken by the major financial scandals. This created the need for the legal and regulatory reform with the aim of promoting and establishing better corporate governance. Consequently, this led to the introduction of compulsory internal audit (IA) both in private and public sector. Nowadays, although the IA is an integral part of good corporate governance (GCG), it has not been researched sufficiently. Because of that, the role of internal auditors in an organization, the level of their independence, the conflicts and obstacles that they face on a daily basis in their work need to be thoroughly examined together with the challenges that have to be overcome in the recent future.

IA is one of the key internal control processes that should have a major role in the management of a particular organization. All important decisions should be made upon the recommendations of the IA department. Modern business principles require that the IA function should be based on an estimation of future trends and predictions of risks. It should not be only focused on the traditional control of already completed processes and accounts. In this paper, the authors will further investigate the challenges of IA in both – private and public sector, which will be supported by the existing literature in this filed. The authors came to a conclusion that focus on risks is the key point to the evolution of IA control function.

## 2. LITERATURE REVIEW

As highlighted by Jackson (2011), only a few professions have experienced such a large degree of change in the last decade as a profession of internal auditing and it is certain that, due to the latest economic crisis, this trend will be continued and even more expanded in future. This author points out that in 20 years' time the practice of internal auditing will look significantly different due to the market changes and technology development. As far as the function changes, its purpose will continue to be essentially considered in the assessment of the organizational activities in companies and institutions.

Regardless of the number of employees, IA is a very complex process that requires multidisciplinary skills and knowledge, as well as the efficient organization of the relevant documentation in order to have a better insight into the company's business, and like any other process in the organization, requires constant upgrading (Shumans and Georgescu, 2014). The size of the IA department does not indicate directly whether this function contributes to the creation of added value for the organization and its effectiveness, as few studies on this topic have concluded. According to Carcello *et al.* 2005, having IA department is not the same as having a department of IA which creates a certain value and effectively responds to the demands of modern markets. Also, some authors like Archambelaut *et al.* (2008) emphasizes the lack of availability of information related to IA to the shareholders



and highlight the need for publicly available reports of IA in order to determine its function and guarantees provided to internal and external shareholders. Also, Chambers (2013) points out that greater transparency is necessary in terms of functions performed by IA, and that this especially applies to risk management, noting that IA does not meet the needs of external stakeholders for information.

Abbott *et al.* 2010 considered the dual reporting structure, where reports are submitted to the audit committee and the management as well, can create conflict situations precisely at times when the focus of IA should be on risk management, since their aversion to the risk is at different levels. On the other hand, Institute of internal audit recommends this method of reporting as an example of best practice in order to achieve a high level of independence and effectiveness when it comes to the IA function (IIARF, 2010a, p. 34).

In addition, IA is responsible for submitting reports containing information about key operational risks and suggestions on how to reduce these risks or to circumvent them. But, the IA is not responsible for the measures that management should take in this direction (Florin *et al.* 2013). Additionally, certain authors (Norman *et al.*, 2011, Rose *et al.* 2013) point out that the contribution of IA in risk management is not sufficiently effective when this function is under the direct supervision of senior management as it puts at risk the independence of the IA function. This danger is further emphasized by the fact that in many organizations, the internal auditing department is used as a training ground for the future members of senior management, which can further undermine the influence of this department and reduce its aversion to risk (Oxner & Oxner, 2006).

### 3. THE FOCUS SHOULD BE ON RISK

Internal auditors are expected to think strategically, while at the same time, they are tactical and detail oriented, providing generated insights into the business processes of the company, internal control and coverage of all risks. As already noted, the IA department in an organization has a large number of users of its services, which are of the consulting nature and which also have to provide a particular form of insurance against risk. IA department represents the agent of the audit committee of a company, while at the same time it is a partner to management. On the one hand, the priority of the audit committee is to reduce a company's exposure to risk, while management objectives include greater exposure to risk since the risk in its slightest degree is a key driver in the creation of added value for a company over time (Ernst & Young, 2006, p. 11).

The modern way of doing business puts the practice of IA in a very complicated position, due to the fact that in some way it acts as a double agent because it has to respond to different initiatives and to adapt to different levels of risk aversion. Bearing in mind that expectations of direct beneficiaries of IA is different, it is unlikely that even one party will be fully satisfied.

In furtherance of raising its performance to a higher level, it is necessary that companies constantly upgrade the basic elements of corporate governance and internal processes. This also applies to the IA function. It is therefore important that the IA function improves its performance and outcomes,

while internal auditors should be considered as an irreplaceable part of an integrated system of risk management, not just as an advisory body whose recommendations can be accepted or bypassed by a management of a company. According to a study of PWC (2013), a much higher percentage of board members in relation to members of the management believe that the features of the IA contribute to the creation value for organization. On the other hand, the IA function is trying to improve its performance, especially in areas that are not part of its traditional focus. However, the report of the Price Water House Cooper's (2013) states that the shareholders are at least satisfied with the performance of IA in the organizations and this applies particularly to the role of IA in the monitoring of newly emerging risk business segments, such as the assessment of large business enterprise that the organization undertakes, introduction of new products in the product portfolio, as well as managing mergers and acquisitions.

The IA function does not have a foundation which is strong enough to be able to adequately respond to the pressures of today's way of doing business and create significant added value for the organization. This especially applies to the developing countries and countries which are in the process of transition. On the one hand, companies are continually improving their operations and strive to raise their performance to a higher level, while struggling with the risks that global environment brings and dealing with the pressures of regulatory bodies and stakeholders. On the other hand, although the IA function develops in width in terms of providing more services and activities performed, improving its performance does not follow sufficiently developments at a strategic level, and this applies particularly to the degree of risk exposure and ways to overcome existing risk threats. This is why the ability of IA function in creating an appropriate level of value for organizations is limited.

The future of IA is based on the establishment of an effective balance between the focus on control and focus on risk management. The IA department and its employees often avoid to engage in the most complex strategic and operational risks because they lack the skills, knowledge and experience to properly approach the analysis of it. However, they have to act in the opposite direction, since in today's business environment, internal auditors often become key advisers in well-established and successful organizations. The key to improving performance is reflected in the necessity of proactive action in terms of organizational adaptation to changes in market conditions, not only in responding to current events. To make this possible, it is essential that IA activities focus on the areas of risk management, management in the narrow sense, outsourcing, e-business and recruitment (Octavia, 2013). When the IA function reaches this stage of evolution, it is possible to create added value for the organization and to improve its performance.

### 4. THE CHALLENGES OF INTERNAL AUDIT IN THE PRIVATE SECTOR

In modern business conditions, the IA function plays an important role in establishing an effective managerial control. Munro and Stewart (2011) state that through the IA process, managers can gain insight into the entire organization, although the core of its operations is based on the audit of final accounts. Due to the dynamics which governs global



markets today, it is essential that internal auditors are properly qualified and thoroughly familiar with the organization of the company, its business, plans for development and internal processes. According to Hull (2003) the main task of IA departments is to be able to recognize and separate functional from non-functional processes in a company, the advantages and disadvantages of its operations and procedures, as well as the level of exposure to risk.

Jackson (2011) states that IA departments are rapidly expanding their portfolio of services, while the audience which has direct interests for the final results of these services is wider than ever. Additionally, modern business conditions require greater depth in the IA, rather than just expanding the number of services of IA departments.

Moreover, expectations in terms of the IA are at a very high level. The recent world economic crisis confirms this statement. The growing expansion and complexity of markets in which organizations are performing and the requirements of regulatory bodies raised the stakes as well. When it comes to the recent crisis, it should be noted that IA did not have a significant role in the emergence of the crisis, but it also was not the important part of its solution.

If we take a look at one of the most famous financial scandals at the beginning of this century, Enron, or at one that took place during the last economic crisis, Lehman Brothers, one most wonder what was the role of IA department. How in these situations the focus of IA was on risk reduction and the separation of functional from the non-functional processes in the company? Lenz and Sirens (2011) in their research reported that the IA department in these companies had identified many shortcomings, but these warnings were ignored. The supervisory committees were not focused on reducing risk exposure and general importance of the IA function. Baker (2010) points out that among stakeholders, in managing of the companies, the IA function was hardly seen as a source of solutions to problems that led to the financial crisis, and that the scope of its participation in the solution of these problems in the aftermath of the crisis has not increased.

It is undeniable the essential thing for the future of profession is to obtain depth in its activities in order to be considered as an important guideline in the GCG practice. Internal auditors have to be reconciled with the fact that in a volatile and transitory periods, there is no perfect practice of internal auditing and the recipe for success and effective reduction of risk at any level.

The current situation in the markets requires internal auditors to submit reports and estimations that are significantly more detailed and precise, based on extensive analyzes and procedures, with the aim of more precise estimation of the future events. IA is now considered in assisting management in order to create realistic picture of the organization's operations, its performance, potential hazards, as well as opportunities for the improvements. Jackson (2011) points out that the future of the IA is about strong analytical skills that will be crucial for predicting the course of organizations.

## 5. INTERNAL AUDIT IN THE PUBLIC SECTOR

When observing the public sector and international institutions in general, the function of IA is essential for effec-

tive management. As the Institute for Internal Audit (2012) points out the IA function in the public sector is of great importance and must be structured in a manner that ensures the fulfillment of their accountability and transparency to the general public, while at the same time allows them to efficiently, effectively and cost-effectively meet its goals. For the IA in the public sector the key point is the credibility and the level of independence with which this function is performed. One must keep in mind that the staff of these departments is also an integral part of particular public organizations, so credibility and independence, as well as their advisory role, are becoming an increasing challenge and the point of potential conflicts of interest.

European commission developed a concept of Public internal financial control (PIFC) with the aim to assist national governments to upgrade their IA environment. Fundamental to the concept of PIFC are three elements:

- (1) Managerial accountability on all levels of the public administration, *i.e.* a public manager is responsible for introducing an adequate financial management and control (FMC) system;
- (2) A functionally independent IA supporting the public manager; and
- (3) A central harmonization unit (CHU), which is responsible for supporting the first two elements by developing methodologies and standards.

One element however, which the PIFC concept does not cover, is the budget inspection. This fact has led – not only in Serbia – to some confusion, but is most probably the cause for the neglect of the budget inspection. Nevertheless, a budget inspection component can play an important role in PIFC systems by complementing IA systems especially in regard to uncovering and prosecuting (major) cases of waste, fraud and abuse of public money. Such a role becomes even more important in developing countries, in which, at least during a transitional period, a serious control gap exists due to the transition from an old (often socialist) system of strong ex-ante control to a control system based on managerial accountability, IA, and an ex-post external audit.

However, the IA function in the public sector differs from one institution to another in the organizational sense, which primarily relates to a method of delivering its services. This is logical, if the complexity and size of the public sector are considered. In many countries the burst of IA faces significant obstacles due to the different strengths of accounting standards that are applied, the availability of institutional capacities and in general existence of social consensus to carry out the audit function across the tree in the public sector. There is a need to strengthen the IA function in the public sector, and this applies particularly to countries in transition and developing countries, where Serbia also belongs.

In Serbia the system of PIFC was introduced in the second half of the 2000s by adopting changes to the budget system law (BSL), which introduced the idea of IA to the Serbian public financial management (PFM) system. A further step was taken in 2010 by establishing a central harmonization unit (CHU), which initially incorporated the responsibility for IA and the already existing budget inspection. In 2012, the budget inspection was separated from the CHU and the budget inspection department (BID) was established as an



independent structural unit in the ministry of finance (MOF) and is subordinated to the minister.

With the amendments and supplements of the BSL between the late 2000s and 2012 Serbia has introduced some major changes to its PFM system and created the legal framework for FMC and IA. However, the definition of the roles and the tasks of the CHU and the IA in the administration are not clearly formulated and/or detailed enough, so that the affected actors deal with a considerable degree of ambiguity.

The introduction of IA on the central level of government, *i.e.* the ministries on the national level, has made some progress; All ministries, except for the two of them, have established and staffed IA units. The state audit institution (SAI) has evaluated the situation of IA in the ministries in the context of its annual audit of the national budget, and approved of it. At the local level however, no reliable data regarding established IA units or the number of certified internal auditors are available. In regard to FMC, a relatively extensive group of people has been trained, but no information is available, whether any, and if so, what consequences in regard to the introduction of FMC systems have resulted from these training. The CHU should continue its FMC trainings, but focus more on the leadership of organizations to foster the understanding of IA reports. Furthermore, the CHU should put more emphasis on networking and the monitoring of the further implementation of FMC and IA, especially in the rollout to the local level.

In order to improve IA function, it is necessary to be regarded as a central component of PIFC that, as such, should be there to protect the financial interests of the public and the government. In addition to conducting traditional activities, the IA function should be able to extract a functional from non-functional processes, but it must be separated from the daily running of the organization. However, certain degree of relationship with top management has to take place in order to assure that it is taking certain corrective actions based on the recommendations, reports and conclusions of this department.

## CONCLUSION

The IA represents a specific control function and its mechanism acts in a way that their actions are actually performed after a certain business action takes over. Historically, both in private and public sector, the internal control and IA are the key segments of this type of surveillance incurred at the same time. However, IA is a main part of the structure of GCG and its task is to ensure the credibility of the process of financial reporting. Moreover, the modern way of doing business imposed the necessity of participation in the risk management to the traditional practice of internal auditing, where the effective fulfillment of all of these functions is crucial for improving the performance of both private and public organizations. IA is not only there to retroactively question the organization's activities, but also to recognize the potential risks and overcome existing ones, in order to create additional value for the organization throughout its evolution process.

## REFERENCES

- Abbott, L.J., Parker, S., & Peters, G. (2010). Serving two masters: the association between audit committee internal audit oversight and internal audit activities. *Accounting Horizons* 24(1), 1-24. doi: 10.2308/acch.2010.24.1.1
- Archambeault, D.S., DeZoort, F. T., & Holt, T.P. (2008). The need for an internal auditor report to external stakeholders to improve governance transparency. *Accounting Horizons*. 22(4): 375-388. doi: 10.2308/acch.2008.22.4.375
- Baker, N. (2010). Board games. *Internal Auditing*, 18-23. Retrieved September 5, 2015 from <http://minutes.southend.gov.uk/akssouthend/images/att17293.pdf>
- Carcello, J.V., Hermanson, D.R., & Raghunandan, K. (2005). Factors associated with U.S. public companies' investment in internal auditing. *Accounting Horizons*, 19(2),69-84. doi: 10.2308/acch.2005.19.2.69
- Chambers, R. (2013). *The Transparency Debate: How Does It Affect Internal Audit?* Retrieved October 25, 2015 from <https://iaonline.theiia.org/the-transparency-debate-how-does-it-affect-internal-audit>.
- Diamond, J. (2002). *The Role of International Audit in Government Financial Management: An International Perspective*. IMF Working Paper, WP 02/94.
- Ernst & Young. (2006). Board Members on Risk. New York, NY: Ernst & Young.
- Florina, P.A., Ludovica, B., & Leonica, B. (2013). Challenges of Internal Audit in Current Crisis. *Annals of the University of Oradea, Economic Science Series*, 22(1), 1354-1374.
- Hull, N. (2003). Sherron Watkins: If capitalists were angels. *Internal Auditor*, 60(11), 38-43.
- Jackson, A.R. (2013). Internal Audit in 2020. *Internal Auditor*, 70(6), 34-42.
- KPMG Forensic.(2006). *Fraud Risk Management: Developing a Strategy for Prevention, Detection, and Response*. Retrieved October 25, 2015 from <http://www.kpmg.com>.
- Lenz, R., & Sarners, G. (2011). Reflections on the internal audit profession: what have might gone wrong? *Managerial Auditing Journal*, 27(6), 532-549.
- Octavia, E. (2013). The Effects of Implementation of Internal Audit and Good Corporate Governance in Corporate Performance. *Journal of Global Business and Economics*, 6(8), 77-87.
- Oxner, T., & Oxner, K. (2006). Boom time for internal audit professionals. *Internal Auditor*, 63(3), 50-57.
- PWC (2013). *A future rich in opportunity: internal audit must seize opportunities to enhance its relevancy: State of the Internal Profession Study*. London: PricewaterhouseCoopers.
- Rose, M.A., Rose, M.J., & Norman, C.S. (2013). Is the objectivity of internal audit compromised when the internal audit function is a management training ground? *Accounting and Finance*, 53(4), 1001-1019. doi: 10.1111/acf.12025
- Sumanschi, G., & Georgescu, L. (2014). Performance Evaluation of Internal Audit. *Economics, Management and Financial Market*, 9(1), 485-491.
- The Institute of Internal Auditors. (2010a). *International Standards for the Professional Practice of Internal Auditing*. Altamonte Springs, FL: The Institute of Internal Auditors.
- The Institute of Internal Auditors. (2010b). *IIA's Global Internal Audit Survey: What's Next for Internal Auditing?* Altamonte Springs, FL: The Institute of Internal Auditors.



## IZAZOVI INTERNE REVIZIJE U UPRAVLJANJU FINANSIJAMA U SAVREMENIM USLOVIMA POSLOVANJA

### Apstrakt:

Finansijska i svetska ekonomska kriza stvorile su potrebu za pravnom i regulatornom reformom sa ciljem uspostavljanja boljeg korporativnog upravljanja. Samo nekoliko zanimanja doživelo je toliki stepen promena u protekloj deceniji, uključujući i oblast interne revizije. Internu reviziju trebalo bi posmatrati kao sredstvo za upravljanje koje će pomoći menadžerima da stvore realnu sliku poslovanja organizacije, ukazati na potencijalne opasnosti, kao i mogućnosti za napredak. Interna revizija se u mnogim zemljama suočava sa brojnim preprekama usled različite jačine računovodstvenih standarda koji se primenjuju, dostupnosti institucionalnih kapaciteta i uopšte postojanja društvenog konsenzusa o obavljanju funkcije revizije u javnom sektoru. U upravljanju finansijama u savremenim uslovima poslovanja prisutna je potreba da se ojača funkcija interne revizije u celini. To se posebno odnosi na zemlje u tranziciji i zemlje u razvoju, među kojima je i Srbija. Autori se bave izazovima sa kojima se suočava interna revizija u privatnom i javnom sektoru, i dolaze do zaključka da savremeni principi poslovanja zahtevaju da se interna revizija zasniva na proceni budućih trendova i predviđanja rizika.

### Ključne reči:

interna revizija,  
javni sektor,  
privatni sektor,  
dobro korporativno upravljanje,  
finansijski menadžment i kontrola,  
interna finansijska kontrola u  
javnom sektoru.